Anticipating change

Our third issue of VantagePoints consolidates perspectives gleaned from meetings this past fall of over 80 audit committee chairs, who together sit on the boards of more than 120 public companies. Meeting participants gathered in cities across North America for candid discussions as part of Tapestry Networks and EY’s regional audit committee networks. One of the common themes that arose from their discussions was anticipating change.

In this issue, we begin with what has become a significant and constructive dialogue among audit committee chairs and members of the Public Company Accounting Oversight Board (PCAOB). Discussions focused on the ways audit quality is improving and could improve further. Areas of exchange included the PCAOB’s process for inspecting audit firms, its planned establishment of a set of “audit quality indicators” to inform audit committee oversight of auditors, and potential adjustments to the auditor’s reporting model. Above all, participants recognized that improving audit quality depends in significant part on audit committees and the PCAOB acknowledging their common goal of fostering audit quality and investor confidence in audited financial reports.

We turn next to a snapshot of expectations for China. Audit committee chairs are keen to understand what a changing China will mean for the global economy generally as well as for their individual companies’ operations. Robert Lawrence Kuhn, a senior advisor to the office of the chairman at EY, offered audit committee chairs his expert analysis of the political, economic, and social dynamics of an emerging superpower at a crossroads.

We then take up the new converged standard on revenue recognition, which goes into effect at the beginning of 2017. It may seem a long way off, but companies will need to understand the complexities of the new standard and be ready to train employees, set appropriate expectations, and communicate new approaches both internally and externally.

We conclude with the topic of risk, which is never far from the minds of audit committee chairs, who highlighted the close connection between strategic planning and risk and examined emerging risks. Audit committee chairs were likewise interested in management’s responses to changing operational, regulatory, and fraud risks that, if not properly identified and understood, can become strategic risks in their own right.

The North American Audit Committee Networks are organized and led by Tapestry Networks and supported by EY as part of EY’s focus on effective corporate governance and commitment to bringing together and engaging with boards and audit committee members. Tapestry Networks and EY are independently owned and controlled organizations. Please reach out to the Tapestry team or EY if you have any questions.
According to Michael Lofing, who leads the risk analysis group as deputy director of the PCAOB’s Office of Research and Analysis, the audit selection process includes screening for factors like industry risks, market capitalization, income-tax controls, accounting estimates, mergers and acquisitions, and hard-to-value investments.

The risk analysis does not stop with the selection of the audit. As Mr. Hanson explained, after the audit itself is picked for inspection, “We look at risk-based slivers of each audit.” In other words, during an inspection, the PCAOB’s inspectors focus on the issues with which preparers and audit teams struggle most, including such items as revenue, internal controls, and estimates.

Because inspections focus on the most difficult issues within the context of the most difficult audits, it is expected that a substantial number of inspections will result in negative findings. As Mr. Hanson put it, “If you have a team of experts [tasked] to find problems, you are likely to find problems.”

In compliance with Sarbanes-Oxley, the PCAOB communicates these problems to the public in Part I of its inspection reports, which list audit-specific deficiencies above a certain severity threshold, while keeping the name of the audited company confidential. Part II of the reports includes the PCAOB’s quality-control evaluation, and, by statute, is generally not public. However, elements of Part II may be made public if problems are not remedied to the board’s satisfaction within 12 months from the date of the inspection report.

For the past several months, as part of the PCAOB’s outreach effort to audit committees, members and staff from the PCAOB have joined audit committee chairs across the country to discuss the audit inspection process, the audit quality indicators initiative, and proposed changes to the auditor’s reporting model. Audit committee chairs appreciated the opportunity to interact directly with representatives of their audit firms’ regulator.

### Inspection process

“We don’t go looking for the easy things; we go looking for the hard ones,” said Mr. Hanson, as he explained the audit inspection process.

The PCAOB is required by statute to inspect registered accounting firms in order to assess compliance with the Sarbanes-Oxley Act of 2002, PCAOB and SEC rules, and professional standards. Every year, the PCAOB inspects accounting firms that audit 100 or more issuers per year, and these inspections include both a review of the firm’s audits and a review of firm-wide standards.

The risk-based manner in which the PCAOB chooses which audits to inspect is not a secret, but neither is it widely understood. Meetings with the PCAOB provided an opportunity to explain the selection methodology, which gave audit committee chairs a better understanding of why reports of inspection results are often critical in nature.

As Mr. Hanson explained, the PCAOB employs a risk-based approach to its selection of audits for inspection. The selection process begins when the PCAOB’s Office of Research and Analysis considers the potential risk for deficiencies in thousands of filings in order to identify those that present the highest risk.
Audit committee chairs meet with the PCAOB: continued

Many audit committee chairs lamented the lack of context and nuance expressed in connection with the inspection reports. 

Conversations among audit committee chairs and the PCAOB revealed a perception of general improvement in audit quality. Some audit committee chairs described instances when a PCAOB inspection revealed otherwise undetected issues, leading to improved processes and stronger controls within their companies. Many participants acknowledged that the PCAOB inspection process could serve as a starting point for better communication between the audit firm and the audit committee, particularly if broader context was provided of a given year’s inspection focus.

But many audit committee chairs continue to wonder how audit improvements can be demonstrated. Nearly every network meeting raised the question of how the PCAOB measures its observed improvement in audit quality.

In a public speech over a year ago, PCAOB member Jeanette Franzel addressed this interest: “A generally understood and measurable definition of audit quality has not emerged over the decades that this issue has been debated and questioned.” Mr. Hanson echoed the point in a recent meeting of audit committee chairs: “Audit quality has improved dramatically since Sarbanes-Oxley, but we do not have concrete measures to prove it.”

In a related effort, the PCAOB has engaged in a project to establish a set of audit quality indicators (AQIs). The PCAOB plans to issue a concept release on its AQI initiative in the near term. In 2013, the PCAOB presented a framework for measuring audit quality with three major elements: inputs, process, and results. Audit committee chairs encouraged the PCAOB to focus not only on which indicators are most appropriate, but also on how many indicators would make a realistic and workable number. In discussions with audit committee chairs, Mr. Hanson noted that the PCAOB was trying to get to a “top-10 list” of “the highest-impact metrics for both input and output.”

In response to these questions, Mr. Hanson highlighted the root-cause analysis initiative currently underway at the PCAOB, which not only looks at what might have gone wrong in an audit but also identifies “practices and other factors that contribute to compliant audits.” Like the inspection process and the audit quality indicators initiative, the objective of the root-cause analysis initiative is to improve audit quality.

Audit quality indicators

The fundamental question of what constitutes “value added” was at the front of audit committee chairs’ minds during discussions with the PCAOB. Several audit committee chairs asked, “How do you know if you are doing a great job?”

Audit committee chairs were intrigued by the AQI initiative and expressed a desire that it will help them to better assess their auditors in a meaningful way.
Mr. Hanson said he believes the proposal that the auditor evaluate “other,” non-financial information – which has received more pointed criticism than the “critical audit matters” component of the proposal – warrants further consideration by the PCAOB. As a result, he expects the two proposed changes might be moved into separate standard-setting projects.

In addition to changes to the auditor’s report, the PCAOB has proposed rules to increase transparency by requiring disclosure of the name of the engagement partner responsible for the audit. Mr. Hanson has elsewhere explained that these proposals are part of the PCAOB’s “mission to protect … ‘the public interest in the preparation of informative, accurate and independent audit reports.’” Where exactly (i.e., to whom and in what form) the engagement partner’s name would be disclosed is still being determined.

Although PCAOB Chairman James Doty and many investor advocates regard the audit report in the 10-K as “the most prominent and straightforward way to give the partner’s name to investors,” Mr. Doty has offered a compromise in response to constituents – including audit firms, the Center for Audit Quality, and others – who would prefer a different means of disclosure. The potential for delays in issuer filings due to the potential requirement of “consents” under SEC rules is an underlying concern with such a disclosure in the audit report.

Mr. Doty has suggested that an alternative may be to allow audit firms to name the partner in a new form that would be filed with the PCAOB. The PCAOB has recently indicated it will seek public comment on this question through a supplemental request for comment before the end of the first quarter in 2015.

Some audit committee chairs expressed concern about the potential consequences of disclosing the engagement partner’s name. “You don’t want to have the audit limited to one person to the exclusion of the rest of the team, including the national office,” one said. Other audit committee chairs, however, were willing to acknowledge the benefits of the proposal. “It would increase the sense of personal responsibility for the work that is being done,” one said. Still other audit committee chairs described the proposal simply as “no big deal.” One noted, “It may not add a lot, but if it gives some higher level of comfort, it’s not a problem to me.”
Robert Lawrence Kuhn, one of the world’s foremost experts on Chinese politics, economics, and business, and the senior advisor, office of the chairman at EY, joined audit committee chairs this past fall to discuss the challenges and opportunities inherent in doing business in China. “Doing business in China today is more complex than it was in the past and requires more attention and sophistication,” he said.

Dr. Kuhn identified several categories of risk associated with doing business in China: political, economic, corruption, intellectual property, regulatory, and Chinese media. He also broke down regulatory risk into three subcategories: policy-oriented regulations; targeted regulations, which are rare but do exist; and ostensibly capricious regulations, which are often the byproduct of jurisdictional disputes between government agencies.

Several audit committee chairs asked what China will be like in five to ten years. Dr. Kuhn responded that if international markets were to remain reasonably stable, China should be able to maintain 6–7.5% growth rates, driven largely by urbanization, and that this level of growth – which is quite high in absolute terms given China’s large GDP of about $10 trillion – could run for another 10–15 years before falling gradually to that of developed economies.

Dr. Kuhn observed, “China’s is a growing but fragile economy, dependent on exogenous forces, which is why China must engage with the world’s political order. China is realizing that it no longer has the luxury of isolating itself from world problems because its economy, more than other large economies, is now tied to the rest of the world. This is another reason why China’s leaders are focusing on building the country’s domestic market, in which attentive international companies can participate.”
With audit committee chairs interested in the pending changes to the revenue recognition accounting standard, which takes effect in 2017, several of the networks covered this topic in education sessions. The headline that emerged from these conversations is that audit committees may need to think sooner and more broadly about the organizational implications for company processes and staff.

Mr. McGaw pointed out, this change is likely to impact large, complex contracts. Where in the past a company may have recognized a contract with multiple elements in its entirety, under the new standard the elements may need to be broken down into different components (referred to as performance obligations) and recognized as they are satisfied. In addition, where contracts include “variable consideration” – components without a fixed price, including bonuses, incentives, rebates, and penalties – companies will be required to estimate the value at the start of the contract and update it over time. Not all companies will be equally impacted; those in the software, telecom, oil and gas, and pharmaceutical industries will most likely be affected. However, several members in the retail industry pointed out that rebates and loyalty programs are likely to create changes for them as well.

One aspect of the transition that attracted audit committee chairs’ attention is the option to use either a full retrospective or a modified retrospective approach to presenting financial statements. The full retrospective would apply to 2015–2017 (with some exceptions) while the modified approach would apply to the most recent period, with a cumulative adjustment and additional disclosures.

Several audit committee chairs commented that companies will likely feel pressure to take the full retrospective approach. One said, “Analysts will ask for it and, anyway, if one competitor does it, you have to do it.” Mr. Day pointed out that once companies make the decision on which approach to use, they should disclose it. Several audit committee chairs raised the question of whether the 2017 deadline might be extended. Both Mr. Day and Mr. McGaw pointed to various industry group efforts underway but said that any decision by the FASB would likely not come until well into 2015.

Understanding and communicating the impact on revenue

Audit committee chairs expressed some concern about whether different stakeholders will understand the revenue recognition changes. One said, “You need to condition shareholders. Do they understand the key drivers of revenue? ... If the numbers go down 2% when retrocast, do they understand why?”
New revenue recognition standard presents an array of changes: continued

While the standard does not take effect until 2017, there are good reasons to start preparing for the transition now, according to EY’s experts and audit committee chairs, who shared the conclusions of their companies’ initial assessments.

Given the large variations among industries, several advisory groups have been set up to represent industries and propose guidance. Because the new standard is principles-based, different companies in the same industry may end up accounting for the same types of revenue somewhat differently.

Audit committee chairs expressed wariness that all this is likely to attract further scrutiny to company disclosures.

Process issues for the audit committee to consider

As with any accounting change, company processes will need to be revised in accordance with the new standard. One area of special concern for the audit committee is the use of judgments and estimates under the new standard. As Mr. Day pointed out, the new standard will require more judgments in estimates, which will likely lead regulators to expect more formal processes. Mr. Day suggested that audit committees would be well served to ask questions about the judgments and estimates process and make sure they are comfortable with both its rigor and consistent application.

People issues for the audit committee to consider

One area audit committees may not have yet considered fully is the impact of the changing requirements on finance staff, including internal audit. One audit chair said, “We have a tenured team and estimating approaches have been consistent for so long now that this becomes a perfect storm.” Mr. Day pointed out that companies that have been relying on a few people to make judgment calls may now need to rely on others who are not as well trained.

How audit committees should move forward

For companies that have already performed a preliminary assessment, Mr. Day suggested that audit committees ask management how they plan to communicate with stakeholders, how they plan to train employees, and how they will monitor the advisory groups that are providing transition guidance on the change leading up to 2017.

QUESTIONS FOR AUDIT COMMITTEE CHAIRS: REVENUE RECOGNITION

What is management’s plan, including a timeline, for a preliminary assessment of the new standard’s effect on the company?

How does the company plan to monitor and consider interpretations by FASB and IASB and SEC staff as well as the American Institute of Certified Public Accountants industry task force?

How is transitioning to the new standard expected to affect the company’s businesses, processes, and financial reporting?
Audit committee chairs also grapple with emerging risks, strategic or not. During discussions, they identified a number of emerging risks: shortages of engineers to design competitive products, failure of the government to properly inspect food and drugs, interest rate volatility, and competitors’ use of disruptive technology to gain market share. One audit committee chair explained, “I’m worried about what is lying in wait. What disruptive technology is coming tomorrow?”

As difficult as it is to tackle strategic and emerging risks, companies must still contend with ongoing operational, compliance, and fraud risks. Within these categories, audit committee chairs frequently single out cybersecurity as riddled with challenges that warrant constant vigilance, both by senior management and the board.19 Mr. Friis recently cautioned a group of audit committee chairs that traditional risk management practices may not be the most effective way to manage the cybersecurity threat – a risk that requires a strategy all its own and tactics that are frequently implemented almost as soon as they are conceived.

Regulatory and compliance risks are also top of mind for many audit committee chairs. Companies too often bear enormous costs when such risks materialize. In 2014, Intel lost its appeal of a €1 billion antitrust fine in the European Union.20 In 2012, GlaxoSmithKline agreed to pay $3 billion in fines as part of a fraud settlement.21 And fines in the financial services industry have reached large proportions: for example, by the end of 2013, JPMorgan had set aside $23 billion to pay future fines and legal bills.22

How does culture affect risk?

The culture of an organization can go a long way toward addressing and mitigating risk. No matter the particular type of risk – operational, compliance, or fraud – audit committee chairs observed that the right talent and human resources strategy is an invaluable element in any risk mitigation.

The board’s oversight of the culture of an organization requires careful observation of management. Several audit committee chairs said that they pay very close attention to how management teams communicate with each other; these board directors look for “a degree of transparency and openness in answering questions posed by a skeptical board,” which can provide comfort about the organization’s culture.
What should the audit committee do?

The way that risk oversight is coordinated at the board level often depends on the industry of the company. At some companies the audit committee is responsible for risk oversight, while at others—including financial institutions—there is a separate dedicated risk committee. Still other companies distribute specific risks among the committees best suited to address them and give the remaining risks to the full board.

Some audit committee chairs agreed that it is best to reserve for the whole board only the top six or seven risks for the entire company. And regardless of how risks are allocated among the full board and its committees, the audit committee frequently "owns the process," if only to ensure that there are no oversight gaps.

Audit committee chairs have observed that an effective risk oversight process requires board directors to remain steadfastly objective and to ask good questions. Reliance on presentations from senior management is not enough. One audit committee chair recommended asking divisional heads to present their risks to the board: "If you meet the people, it gives you a better feel for what they are dealing with."

No matter the risk governance structure, audit committee chairs agreed that risk oversight remains more art than science, and, in the words of one audit committee chair, "Despite all the charts and models, it still requires intuition."

Mr. Friis recommended that boards review incentive structures and performance measures as critical indicators of a company’s culture: "Look at who is getting ahead in the organization and why. If someone is not living the values of the organization, is there a decent chance of finding out?"

Getting the talent strategy right is particularly important for organizations currently doing business or planning to do business internationally. Finding the appropriate admixture of "headquarters expats" and local employees is a key to success in international operations. On the domestic side, audit committee chairs might want to ask management how it plans to bring those with international experience back to the home country in order to foster diversity of thinking and inject an international perspective into domestic practices.

QUESTIONS FOR AUDIT COMMITTEE CHAIRS: RISK OVERSIGHT

What emerging risks are most relevant to your company?
What types of disruptive risk are you most concerned about for your company?
How often does your board or audit committee conduct a full review of large strategic risks?
How does your board coordinate risk oversight responsibility between the audit committee and the risk committee (if there is a separate risk committee)?
With whom do you speak in management about operational, compliance, and fraud risks, respectively?
How do you verify that management is living up to the company’s stated culture and values expectations?
VantagePoints, Issue 3, January 2015

Endnotes

1 VantagePoints is produced to stimulate timely, substantive board discussions as audit committee members, management, and their advisers endeavor to fulfill their respective responsibilities to the investing public. This document reflects the network’s use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

2 Any views expressed by members of the PCAOB Board or staff are their own and do not necessarily reflect the views of the Board, other Board members or members of the Board’s staff.


4 Ibid.


6 Ibid.

7 Ibid.

8 Public Company Accounting Oversight Board, Auditing Standard No. 16: Communications with Audit Committees (Washington, DC: Public Company Accounting Oversight Board, 2012), A4-44. (“The Board encourages firms to communicate effectively with audit committees about inspection matters. [A firm is not restricted] from disclosing to an audit committee nonpublic information regarding PCAOB inspections (including quality control deficiencies and the firm’s remediation of those deficiencies) or PCAOB disciplinary matters.”)

9 Public Company Accounting Oversight Board, Information for Audit Committees About the PCAOB Inspection Process, 2.


11 Ibid., 10.

12 Jeanette M. Franzel, “Accountability: Protecting Investors, the Public Interest and Prosperity” (Association of Government Accountants’ 62nd Annual Professional Development Conference, Dallas, TX, July 17, 2013).


18 Ibid.


### UPCOMING EVENTS
Audit committee chairs in Tapestry’s invitation-only audit committee networks in North America plan to discuss the following topics in the current and upcoming months:

<table>
<thead>
<tr>
<th>Topic</th>
<th>Location</th>
<th>Date</th>
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<tbody>
<tr>
<td>Improving audit committee effectiveness</td>
<td>Chicago</td>
<td>January 13, 2015</td>
</tr>
<tr>
<td>The audit committee and corporate culture</td>
<td>Palo Alto</td>
<td>January 29, 2015</td>
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<tr>
<td>The audit committee and corporate culture</td>
<td>Toronto</td>
<td>February 3, 2015</td>
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<tr>
<td>How cybersecurity challenges are evolving and what audit committees need to consider</td>
<td>New York</td>
<td>February 4, 2015</td>
</tr>
<tr>
<td>The audit committee and corporate culture</td>
<td>Santa Monica</td>
<td>February 17, 2015</td>
</tr>
<tr>
<td>Large-scale project management risk</td>
<td>Washington, DC</td>
<td>February 18, 2015</td>
</tr>
<tr>
<td>The board’s role in strategy</td>
<td>Miami</td>
<td>March 3, 2015</td>
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